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Central Intelligence Agency



Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

26 March 1985

China: Bank Support to Rural Development

Summary

Beijing is adjusting its rural banking system to meet the needs of the rural reform program. In recent years:

- Agricultural banks and credit cooperatives have altered their loan priorities to support the development of specialized households and rural industries.
- The State Council has granted rural banks and credit cooperatives increased autonomy to conduct bank operations.
- The central government has raised interest rates on loans and deposits while allowing banking authorities greater flexibility in setting rates.

Rural banking reforms are designed to increase the ability of banks to respond to local credit needs and to improve the allocation of funds in the countryside.

We believe that the rapid growth last year in rural industrial production results, in part, from rural credit reforms already implemented. Government policy encouraging further development of diversified farming and township and village

This memorandum was prepared by [redacted] China Division, Office of East Asian Analysis. Comments and questions are welcome and should be directed to Chief, Domestic Policy Branch [redacted]

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industries, however, will put increasing pressure on the rural banking system to provide funds for investment. Although risking local failures and some loss of central control over rural credit, continuing bank reforms should improve the rural banking system's ability to support rural development.

REFORMS IN RURAL BANKING

Introduction of the household responsibility system, increases in purchase prices of agricultural staples, and extensive development of rural industries have caused a surge in the supply of and demand for funds in China's countryside. The volume of work conducted by the rural banking system has increased enormously in the last six years, with the number of farm clients increasing from 6 million production teams to over 170 million peasant households. Beijing has responded by shifting rural loan priorities, by allowing greater decisionmaking autonomy at all levels in the rural credit network, and by raising interest rates on loans and deposits offered by rural banks and credit cooperatives.

Beijing's commitment to continued reform of the system was underscored in a speech by Vice Premier Wan Li at a national rural work conference last December. Complaining that the rural banking system is not yet adept at absorbing and efficiently distributing idle funds in the countryside, Wan maintained that it is imperative to speed up the transformation of agricultural banks and rural credit cooperatives from fund distributing administrative organs to independent banks operating under broad state supervision. Wan also praised the efforts of peasants in raising and pooling funds outside the rural banking framework.

RURAL CREDIT POLICY

China has initiated two major changes in rural credit policy since 1983 to support the readjustment of production in the countryside. First, agricultural banks and credit cooperatives have switched from primarily supporting communes, production brigades, and collectives to offering greatly enhanced support for individual, and particularly specialized, farm households. Second, rural banks have shifted from mainly supporting agricultural production to encouraging development of rural industry, including storage, transport, and marketing operations.¹ Apropos of the second change, agricultural banks

¹Table 1 lists assets and liabilities for the Agricultural Bank of China in 1983 and 1984, [REDACTED] Some of the amounts in the table do not correspond to Chinese published amounts and we have not yet attempted to reconcile them.

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have been given primary responsibility for handling monetary affairs for industrial and commercial operations in the rural areas.

In 1985, Beijing plans to provide enhanced banking support to rural industries. According to press reports early this year, the Agricultural Bank of China (ABC) and the rural credit cooperatives (RCCs) will increase their total volume of loans by 20 percent, with loans to rural enterprises projected to increase by 30 percent, while loans to the agricultural sector are expected to grow only 10 percent.² Loans for animal husbandry, forestry, and fisheries are projected to increase by 70 percent, 50 percent, and 15 to 20 percent, respectively. If the planned allocations are realized, by the end of 1985 the combined loan portfolio for the ABC and the RCCs will have the following composition: 41.4 percent will be loans for agricultural production, 49.2 percent will be loans for rural enterprises, 1.1 percent will be loans for animal husbandry, and 8.3 percent will be loans for forestry, fisheries, and side-line activities.

Rural banks will adjust interest rates to support Beijing's rural development policies. Preferential rates will be offered on loans to nonfarming enterprises including food and fodder processing industries, small-scale energy projects, and building materials production. Preference also will be given to existing enterprises seeking funds for modern technology to upgrade facilities. Agricultural banks will continue to support irrigation projects, rural mining operations, transport and marketing activities, and the adoption of scientific farming methods. Rural banks will offer loans to farmers for use in purchasing agricultural inputs, but farmers will be urged increasingly to make use of their own funds to finance agricultural production.

The ABC plans to promote rural development by offering grants of 300 million yuan a year for the next six years to China's most economically deprived counties. In 1985, the ABC will also provide 300 million yuan in special development loans for the same areas.

²At the recently convened National People's Congress, Beijing ordered the People's Bank of China to establish quarterly credit ceilings for each of the specialized banks (including the ABC). We do not know whether the ABC and the RCCs will now have to curtail their plans to increase loan support to the rural sector this year, but rural banks are likely to react to any credit tightening by putting increased pressure on borrowers to speed up repayment of loans--especially those that are overdue.

BANK AUTONOMY

Beijing recognizes that budgetary problems will prohibit the state's financial departments from increasing their investments in the countryside for some time. Since continued rural development will depend largely on the ability of the rural banking system to acquire funds from peasants, rural banks and credit cooperatives have been granted increased autonomy and a broader range of operations.

Agricultural Bank of China

Beijing has reduced the proportion of savings that the ABC must hand over to the People's Bank of China (China's central bank) and now allows the ABC to redistribute funds within the rural banking network. Rural banks have increased flexibility in approving (or denying) loan requests for technological transformation and other projects. To enhance the ability of rural banks to support industrial development, Beijing has removed the restriction that all ABC loans be made during the spring planting season.

For the past two years, rural banks have been allowed to extend loans to small, privately-owned businesses in the countryside. Similarly, families engaged in rural production are allowed to hold individual accounts at rural banks and credit cooperatives. Some provincial branches of the ABC now offer loans to farmers for purchasing automobiles and large farm machinery (provided the farmers supply one-half of the required capital), while other provincial agricultural banks have expanded their network of RCCs, establishing credit cooperatives at the village level.

Rural Credit Cooperatives

In order to increase rural savings and to improve the allocation of rural funds, the State Council last August released a circular encouraging reform of the credit cooperative system. The circular proposed a gradual transformation of the credit cooperatives into independent economic entities responsible for their own profits and losses, collectively owned at the village level through peasant shareholding.

Guidelines announced at the provincial level suggest that the RCCs:

- Will be controlled locally by a "cooperative members' representative assembly" which will elect cooperative directors and oversee planning and financial management.
- Will have freedom to determine the nature, recipients, amounts, and terms of loans it offers, without ABC approval.

- Will be allowed to set loans rates within a 20-percent band of the state-determined rate.
- Will give priority to shareholders (which may include village workers and rural enterprises) when extending loans.

Agricultural Bank officials, however, have used the credit cooperatives as their own branches, and continue to oppose an independent role for the RCCs. According to Embassy reporting, the ABC thus far appears to have been successful in stalling the reforms.

Popular Credit Institutions

In what is perhaps a concession to an already established practice, Beijing has recently encouraged peasants to form private credit institutions to support the development of rural factories and transport and power networks. These "popular" credit institutions--often taking the form of local credit unions or joint stock operations--were praised by Wan Li in his December speech as important supplements to the ABC and the RCCs. According to provincial media, popular credit institutions often outbid rural banks and credit cooperatives for funds by offering higher rates of return, and extend loans at above-bank rates to peasants and enterprises that have no other place from which to borrow.

We believe that Beijing's willingness to loosen control of rural credit and risk complaints about usurious interest rates reflects a disappointment with the pace of reform in the rural banking system. In his speech, Wan referred to unresolved structural problems that limit rural banks and credit cooperatives. Supporting the development of private credit forms may also be an attempt to diminish the control of rural cadres over credit in the countryside.

INTEREST RATES

On 1 January, 1984, China raised the basic monthly interest rate for agricultural production loans from approximately 0.45 percent to 0.6 percent, giving the head office of the ABC discretion to adjust the rate upward or downward within a 20-percent range.³ The increase was designed to bring loan rates in line with credit conditions in the countryside and the discretionary range was instituted to enhance the ability of rural banks to differentiate between borrowers.

³Table 2 gives monthly interest rates on loans and deposits at rural banks in 1984.

The increase in loan rates was also implemented to correct the inverted interest rate structure that was adversely affecting the profitability of rural banks and credit cooperatives. The success of the household responsibility system in agriculture caused a large increase in savings deposits held by individual peasants (which earned a monthly interest rate of 0.24 to 0.75 percent compared with the 0.15 percent received for deposits by commune and brigade collectives). As the proportion of high-interest-rate deposits increased, the cost of rural deposits exceeded the interest that agricultural banks and credit cooperatives received from rural loans.

OUTLOOK

We believe that the rapid growth in China's rural industrial production last year resulted, in part, from loan support provided by the ABC and RCCs. Loans from private credit institutions also appear to have provided an important boost to village-level enterprises. Beijing's policy encouraging further development of diversified farming and rural industries, however, will put increasing pressure on the rural banking system to provide funds for investment.

Reports that interest rates on private loans are considerably higher than rates on bank loans, along with official criticism of the rural banking system for its inability to absorb and efficiently use idle funds, suggest to us that substantial barriers exist which inhibit the transfer of credit within the system from surplus to deficit areas. Granting rural banks and credit cooperatives more latitude to set interest rates and screen potential borrowers should help improve the allocation of funds in the countryside.

Expansion of credit to specialized farm households and privately-operated rural enterprises will inevitably lead to instances of borrowers who are unable to repay loans. Beijing maintains that because the state owns the land, peasants cannot go bankrupt and will always have claim to a plot of "food grain" land. Supposedly, the state and local authorities will aid peasants who become financially overextended. Beijing, however, has not spelled out a policy for handling bankruptcies in the countryside, and we believe it may not understand fully the dimensions of the potential problems.

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Table 1

Balance Sheet for Agricultural Bank of China
(figures in billions of yuan)

	1983	1984	Percent Change
<u>SOURCES OF FUNDS</u>			
Deposits by State-Owned Agricultural Enterprises and Institutions	5.6	6.6	18
Deposits by Industry and Commerce in the Rural Areas	3.9	9.6	147
Deposits by Township Enterprises ¹	2.1	0.8	(62)
Savings Deposits in the Rural Area	6.8	9.7	43
Deposits by Credit Cooperatives	35.5	32.8	(8)
Deposits by Government Organs and Other Organizations	4.1	3.5	(15)
Other Deposits	3.6	3.4	(6)
Deposits from Funds Alotted by the State for Agricultural Production	1.0	1.2	20
Intercourse Among Banks	15.0	35.8	139
Funds Owned by ABC	22.0	21.1	(4)
Surplus	1.4	1.7	21
Total	101.0	126.2	25
<u>USES OF FUNDS</u>			
Loans to State-Owned Agricultural Enterprises	3.9	5.1	31
Loans to Industry and Commerce in the Rural Areas	45.0	71.4	59
Loans to Township Enterprises ²	16.3	7.7	(53)
Loans to Peasants	1.9	4.4	132
Loans to Credit Cooperatives	1.6	3.1	94
Loans for Advances ³	0.7	0.7	0
Other Loans	2.1	2.1	0
Agency Services ⁴	29.5	31.7	7
Total	101.0	126.2	25

¹Formerly titled "Deposits by Communes and Production Brigades."

²Formerly titled "Loans to Communes and Production Brigades."

³Formerly titled "Loans for Forward Purchases."

⁴Formerly titled "Business Done on Other Banks' Behalf."

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Table 2

Monthly Interest Rates at
Rural Banks in 1984

LOAN RATES

- 0.42 - 0.54 percent for energy development loans (rates were lower for small hydropower development),
- 0.48 - 0.90 percent for loans to contract, specialized, or key households (lower rates were for short-term personal loans, higher rates were for farmers engaged in commercial activities),
- 0.60 - 0.66 percent for loans to collectives and brigade-run enterprises,
- 0.72 percent for loans to individuals engaged in rural sideline industries, commerce, and transportation.

DEPOSIT RATES

- 0.24 percent for demand deposits,¹
- 0.48 percent for one-year deposits,²
- 0.57 percent three-year deposits,
- 0.63 percent for five-year deposits,
- 0.75 percent for eight-year deposits.

¹Prior to 1980, the monthly interest rate for demand deposits was .18 percent.

²Prior to 1980, the monthly interest rate for one-year savings deposits was .33 percent.

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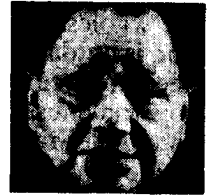
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The more Deng the better



The longer its old leader lasts, the likelier that China's change will move in the right direction

The Chinese are coming, the Chinese are coming. But not to worry, Mr Gorbachev; they won't catch up with Russia until some time next century. Those bumptious peasants are aiming at quadrupling their 1980 income by the year 2000. To reach that target, China would have to grow at 7% for 15 more years, which would be something of a feat even for disciples of Mr Deng Xiaoping. All that growth would still leave China at the turn of the century with a real gross national product only two thirds the size of Russia's today, divided among four times as many people. So unless the Soviet Union actually slips backwards, there will be no hot Chinese breath on stiff necks in the Kremlin: just the subversive sound of a billion sometime communists making up lost ground at a super-capitalist pace.

There is, however, one important condition. China can probably complete its long-distance sprint, provided at least two more generations of Chinese leaders have the political puff to stay the course. And the course is bound to become progressively bumpier as 80-year-old Mr Deng, his soon-to-be septuagenarian successors and his six-year-old reform programme get on in age. The easiest gains, from decollectivising farming, have already been pocketed by China's newly prosperous peasants. The next steps—liberating both agriculture and industry from centralised planning and pricing—involve more complicated economics and more dangerous politics. The question is whether these hurdles can be leapt by anybody except Mr Deng.

It did not take a third Kremlin funeral in three years to alert China's innovator-in-chief to his own mortality. Historians may well rate Mr Deng's contribution to his country as greater in some ways than old Chairman Mao's. But he seems already to have ensured that his passing will be no more eventful in the short run than that of Russia's late Chernenko. Not only have two able heirs, Mr Hu Yaobang as party general secretary and Mr Zhao Ziyang as prime minister, been running China's daily Dengist business for three years now. The successors have successors in place.

One of these, Mr Hu Qili, a contemporary of Mr Gorbachev, supervised the drafting of the recent plan for extending market principles into industry. Hu the Younger runs the party secretariat under Hu the Elder. Along with Mr Zhao's state council, the secretariat has usurped the policy-making functions of the party politburo. This is the Dengists' way of making an end-run round the politburo, which is dominated by conservative ancients. The party leaders are now preparing for a conference next September whose main task will be to shake out unDengist wood from the party's central committee. Every time a young technocrat replaces an old footdragger in the party, government or army, the chances of Dengism surviving are increased. The army,

long the refuge for unreconstructed Maoists, recently pensioned off 40 generals; another 47,000 over-age officers are due to go in the next two years.

For those Chinese who would like to block or even roll back the Dengist reforms, the golden age was the 1950s, when China took Russia as its model and gloried in central planning. Today nobody is arguing openly for a revival of the subsequent Maoist excursions, the Great Leap Forward and the Cultural Revolution. The conservatives are merely pressing for a reassertion of central controls, a re-emphasis on heavy industry, and a restriction of foreign influence and investment. They make their case by seizing on the social problems which inevitably accompany social change.

Mr Deng, the master tactician, has been responding to conservative pressures these past six years by retreating here and bulldozing there. At the moment he and his allies are on the defensive again over "unhealthy tendencies" such as corruption and capitalist thinking. A recent government audit found \$1 billion worth of "irregularities" in state enterprises last year. In a speech two weeks ago, Mr Deng fended off his enemies by invoking "socialist principles" and the "ultimate shift to communism". Although he gave no ground on the profit motive, he had to sanction new drives for party discipline and ideological re-education. The latest concessions to the hardliners are probably no more serious or less temporary than a dozen other Dengist zigzags over the past six years. Still, they revive doubts about whether less seasoned operators than Mr Deng will be able to keep the reformist bulldozer rolling.

Just another Hungary—or better?

It is unlikely to move backwards. The anti-Dengists have the capacity to make mischief. But the constituency for reform—peasants, intellectuals, buyers of washing machines—is now too big to be ignored.

The real issue for the coming years will be the pace of economic change, which will amount to a choice between two models of development. Mr Deng Xiaoping has his sights set on the example of China's post-Confucian neighbours, who have already done that income-quadrupling trick in less than two decades. Places like South Korea and Taiwan prove that free economies do not require free politics—though they do demand freer flows of information than either China or Russia allows now. But to achieve east Asian growth rates, China would have to take high risks, starting with exposing its arbitrary price structure to the free market.

The softer alternative would be to settle for the Hungarian variant of pseudo-market socialism. The Hungarians replaced their Stalinist command economy with indirect bureaucratic controls. They continue to prop up lame ducks, set arbitrary prices and put politics

banks and thrifts from the boondocks now going into the wholesale money markets for funds, that assumption is outdated. The Federal Reserve and the treasury need to take a greater interest in the middlemen in government securities—and weed out the incompetents and undesirables before they cause others grief, as Drysdale Securities caused grief in 1982 and ESM has done to Home State Savings Bank and others this month.

Preventing a loss of confidence among depositors throughout the banking system, without protecting individual banks from competition, is a harder task. Free-market fundamentalists argue that full insurance of deposits inhibits competition because depositors have little incentive to choose better banks. But in the real world any attempt to make American banks compete more freely by dismantling deposit-insurance schemes is just about the best way to risk turning local banking panics into a national (or even international) banking crisis.

Instead, the few remaining state insurance schemes ought to be folded into federal insurance, as Ohio is doing. First, because federal regulators are usually

better qualified and are much better placed to see trouble coming now that hardly any financial business is confined by state lines. Second, because individual depositors cannot be expected to learn to draw a distinction between rickety and sound banks.

Bankers and big investors, however, can be expected to learn something from their mistakes. Most of the recent losses in American capital markets have come because bankers and investors did not understand the risks they were taking. ESM was able to sell more government securities than it actually owned because many buyers were too ignorant or careless to take physical possession of those securities. The more the gulled suffer, the less likely are others to repeat their mistakes.

So try to make sure the managers lose their jobs, and the bank's shareholders their investments, when commercial or savings banks fail. It is the depositors who need rescuing. Mr Paul Volcker rightly promised to do this when he told a meeting of the National Cattlemen's Association (yes, really) that the Fed was prepared to keep lending funds to the savings banks in Ohio "until they are deemed strong enough to reopen".

A bad time to flicker



Sir Geoffrey Howe hasn't helped a star-wars agreement

At first sight, Sir Geoffrey Howe's star-wars speech of March 15th is an admirable example of the Ooh-Ooh approach to difficult subjects. On the One Hand, On the Other Hand, goes this approach: and for a careful bureaucrat, or an undecided academic, it is a fine way of starting down the long, winding road to ultimate truth. The British foreign secretary's analysis of the pros and cons of President Reagan's Strategic Defence Initiative was calm, thorough and balanced. A good defence specialist would be delighted to have written it. With one exception—what exactly "deterrence" consists of—its arguments have all appeared in *The Economist*. It was, nevertheless, a mistake.

Was he carrying Mrs Matchmaker's banner?

Sir Geoffrey is neither a bureaucrat nor an academic; he is a politician. He therefore understood perfectly well that everybody would pass lightly over his on-the-one-hand pro-Reagan points (such as the fact that Russia has an SDI of its own—see page 47—and that Mr Reagan has been quite diffident about the prospects of America's anti-missile research), but would leap on his on-the-other-hand doubts and head-scratchings—the cost and uncertainty of the whole thing, the danger that it might make deterrence harder, not easier, the "Maginot line" phrase. He knew what he was doing. The only question is whether Sir Geoffrey did it to separate himself from Mrs Thatcher's apparently more tolerant view of SDI, or was carrying a banner for Mrs Thatcher herself. The answer is almost certainly the latter.

Ever since she entertained Mr Mikhail Gorbachev in Britain last December, Mrs Thatcher has shown signs of wanting to be a matchmaker between him and Mr Reagan. Trying to tug Russia and America together is not a new phenomenon among west European politicians. Mr Harold Macmillan felt the urge; so have some recent West German chancellors. The problem is not just that the would-be European matchmakers have relatively little influence over the superpowers. In the present missile-and-anti-missile debate, the time for matchmaking has not yet arrived.

It would be wrong, as Sir Geoffrey would agree, to call for a ban on anti-missile research. Both sides are doing it; the Russians, at any rate, would not open up their laboratories to foreign inspectors; and, who knows, the research might throw up some useful answers. Nor would it make sense to ask both sides to promise in advance that even fruitful research will never be put into practice.

The eventual matchmaking hope in Geneva lies in the possibility of America and Russia agreeing (a) to reduce their missile armouries while (b) writing down the rules by which both might move from anti-missile research to useful deployment, if the research proves that practicable. They are so far only nibbling at the edges of that negotiation. Signs of wobbling on the western side, such as Sir Geoffrey's speech, will encourage the Russians to hold out for ban-it-all western concessions, instead of plodding on towards the desirable deal. Which, to put it mildly, would be a pity.